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A Critical Analysis of the linkages between the formal & the informal rural financial set-ups

INDEPENDENT RESEARCH PROJECT

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INTRODUCTION

Over the last 4-5 years many private banks and insurers have entered the microfinance market by establishing direct financial and facilitating linkages with less formal actors. For example ICICI Bank, India's second largest commercial bank partners with MFIs in unique ways to extend credit directly to Self Help Groups (SHGs) in rural areas. AVIVA Life India, a leading global insurer, uses MFIs to expand life insurance products to rural people. And in limited cases some MFIs even act as formal retail agents for the company which allows them to offer life insurance products to the general public. In Tanzania, CRDB Bank Limited, a private bank has aggressively entered the market by offering MFIs a range of financial services from long and short term loans and credit lines to various payment and transfer instruments. To do this the bank has set up an entire microfinance unit dedicated to the development of this new market segment.

However, in case of Indian banks this seemingly internally driven linkage was initially motivated more by the imperative of regulatory compliance, after acquiring new banking assets rather than by autonomous action. The so-called priority sector targets, which require all commercial banks to lend at least 40 percent of their net credit (at an interest rate not more than 4 percentage points above their prime lending rate) to priority sectors – rural areas, small industries, exporting firms, housing and agriculture – forced many banks to take initiatives to reach further and deeper into 'priority areas'.

Conditionality's embedded into the linkage contract, typically by the formal institutions, are often binding on their less formal partners. It is observed in the past that some MFIs were compelled to accept restrictive terms and conditions from funders. MFIs often do not have a choice but to accept this conditionality's, since their own regulatory status prevents them from accessing capital through deposit taking or straight loans.

RELEVANCE OF THE STUDY

Though the government of India has tried its best, such that the financial services should reach to the rural poor through formal financial institutions, but still a huge gap between the rural poor and formal financial mechanism was seen over the years.

Micro Finance Institutions are born out of this situation, where they have tried to distinguish themselves from the local moneylenders and still have managed to cater services to the large chunk of people living in rural areas.

Here, there is a need of MFI's and formal financial institutions to create a link between them so that they can cater to the huge untapped rural financial market, & can reach to the millions who are out of the purview of formal finance.

Though this link, as we have seen in the past is created but still it is believed that there is a scope of tremendous improvement into it. MFI's are dependent on these formal institutions for financial as well as operational cash management systems.

This linkage between the MFI's & the banks should be such, so that it could match the requirements of the both i.e. The Micro finance Institutions as well as formal banks.

This study will focus on various practices & attitudes which are followed up by the various banks & MFI's to maintain the relationship. It would reveal good as well as bad practices which are being followed up during the creation of this linkage. The study will also tell the problems of the formal financial institutions as well as Micro finance institutions in maintaining a healthy linkage.

Thus this study will try to understand the link and also will try to find out the loopholes existing in the system so that those can be replaced by the best practices which are available in order to benefit those who are residing in rural India.

OBJECTIVES & METHODOLOGY ADOPTED FOR THE STUDY

These are the objectives of the study which are fulfilled during the study -

- To critically analyze terms & conditions of the formal banks & its suitability to the MFI's.
- To study in detail the financial interdependence of the MFI's on the formal banking system, there customized needs & recommendations.
- To identify the strengths & weaknesses of both the systems & work out the remedial measures.

Methodology adopted for achieving above given objectives –

In this study primary and secondary data is collected from the two commercial banks, which are located in Bhubaneswar & are working with the MFI"s in the area i.e. ICICI Bank & AXIS Bank.

Visit was also done to Punjab National Bank, but it couldn't help .Two microfinance institutions are covered in the study i.e. Adhikaar & Gram-Utthan.Adhikar's office is situated at Khandgiri where as head office of Gram-Utthan is at Kendrapara.

A structured questionnaire was formed & interviews of the office bearers were taken who are at the decision making level & at the implementation level in these organizations.

Secondary data was collected from the circulars & reports of the banks which are dealing with the finances of Micro Finance Institutions.

In-depth Interviews were taken with the help of structured questionnaire which were separate for the MFI's & for the Banks related with their financial linkages.

FIELD & OFFICE WORK DONE DURING THE STUDY

In the past two months I performed various crucial activities regarding my IRP, they are as follows:-

- Literature Review was done so that, objective of the research could be formulated.
- Questionnaire formation for the MFI's & the bank Officials in consultation with Professor S.P. Das.
- Visit to the MFI,s & Banks to fix up suitable time for the study to be conducted.
- Visit to the head office of Gram-Utthan which is located at Pimpuri in Kendrapara District of Orissa & in depth interviews of all the office bearers especially the Manager Finance & Manager Operations. It took around six hours to reach there & six to seven hours of return journey by bus. Visit was painful but still fruitful as the relevant information was extracted from the officials.
- Visit to ICICI bank in Bhubaneswar & collection of relevant information with printed documents available.
- Visit to the head office of an MFI Adhikar located at Khandgiri in Bhubaneswar & an in depth interview of the Chief Financial Officer present at the office.
- Visit to a Branch of Axis Bank at in Bhubaneswar to understand their behavior towards this linkage.
- Analysis & Compilation of the all qualitative data collected from the various sources & preparation of a meaningful report.

BRIEF INTRODUCTION OF THE INSTITUTIONS INVOLVED IN THE STUDY

Gram-Utthan

GRAM-UTTHAN is an MFI, working primarily in Kendrapara and Six other adjoining districts in the state of Orissa. It has been one of the leading developmental organizations not only in the district but also in the state. Initially it started developmental intervention in Pimpuri village of Kendrapara district, today it has become one of the major developmental agencies recognized and appraised by local, regional, national and even international development partners.

Registered Under Societies Registration Act XXI of 1860. Registered under FCR Act 1976.Registered Income Tax Registration No: Tech. 12A –54 / 2004-2005 (GRAM-UTTHAN has obtained 80 G) .At present GRAM-UTTHAN is leading towards NGO-MFI to NBFC. Legal entity has been obtained and RBI clearance is awaited.

Mr. Subrat Kumar Singhdeo is currently the President of the Governing Body of Gram –Utthan.

Adhikar

Adhikar is an organization committed to social cause of protecting human rights of the poor and the down trodden, particularly of rural women. It is a voluntary organization involved in a multitude of activities with a relentless and selfless serving attitude, committed to an integrated community development through a process of empowerment of rural people in general and the women folk, in particular.

In 1991 Adhikar is registered under the Societies Registration Act of 1860, addition to this the other registrations like Foreign currency Reregulating Act under Ministry of Home affairs & 12A under Income Tax Dept. of Govt. of India was done to address the legal formalities. Adhikar is a democratic, secular and non political organization with a General Body and

Executive body at the apex level for the purpose of formulation of policy for the Organization. The President as well as the Chief Executive of Adhikar Mr. Mohammed Nuruddin Amin is leading the organization.

AXIS Bank

Axis Bank (formerly UTI Bank) was the first of the new private banks to begin operations in 1994. The bank has been promoted jointly by the Unit Trust of India, Life Insurance Corporation of India, General Insurance Corporation Ltd. and its associates, viz., National Insurance Company Ltd., The New India Assurance Company, The Oriental Insurance Corporation and United Insurance Company Ltd. The bank has a very wide network of more than 450 branch offices and 1891 ATMs.

Consumer banking, NRI services, retail loans, corporate banking, treasury, capital markets and financial advisory services. For the September 2008 quarter, the bank recorded an operating profit of Rs 874 crore.

The bank's registered office is at Ahmadabad and its central office is located at Mumbai.

ICICI Bank

ICICI Bank is India's second largest bank with consolidated total assets of over Rs. 484,000 crores and net worth of over Rs. 47,000 crores. It made a profit after tax of Rs. 4,158 crore in FY2008.

ICICI Bank began its life 1994 as a wholly-owned subsidiary of ICICI Limited, an Indian financial institution, whose shareholding in the bank was reduced to 46 per cent through a public offering of shares in India in 1997-98, an equity offering in the form of ADRs listed on the NYSE in fiscal 1999-2000, the ICICI Bank's acquisition of Bank of Madura in fiscal 2000-01, and secondary market sales by ICICI to institutional investors in fiscal 2001 and fiscal 2002.

In 2002, ICICI was merged with ICICI Bank to combine the wholesale and retail operations of both organizations into a single entity. (ICICI, or the Industrial Credit and Investment Corporation of India was formed in 1955 as a development financial institution at the initiative of the World Bank, the Indian government and representatives of Indian industry.)

ICICI Bank's shares are listed on the Bombay Stock Exchange and the National Stock Exchange of India Limited in India and its ADRs are listed on the New York Stock Exchange.

ICICI Bank offers a range of banking products and financial services to corporate and retail customers through several delivery channels and specialized subsidiaries and affiliates. The areas include: investment banking, life and non-life insurance, venture capital and asset management.

ICICI Bank set up its international banking group in fiscal 2002 to cater to clients' cross-border needs. It currently has subsidiaries in the UK, Canada and Russia, branches in Singapore and Bahrain, and representative offices in the US, China, UAE, Bangladesh and South Africa.

ICICI Bank, which accepts deposits under various savings and fixed schemes, offers a range of loans for various purposes, including housing, cars and 2-wheelers, commercial vehicles, farm equipment, medical equipment, office equipment and construction equipment.

The bank also has a popular credit card business.

ICICI Bank has a network of about 573 branches and extension counters and over 2,000 ATMs.

HOW THIS LINKAGE IS EVOLVED

Financial linkage is defined as any mutually beneficial partnership between a formal and a less formal institution that results in the expansion of rural financial services

MFI's & Bank linkage has not come up in a day, several years have gone into it to make this relationship smoother. Microfinance has been in practice for ages though informally. Credit demand by the poor in the country is estimated to be about Rs. 60,000 crores annually & which is still not fulfilled by these micro finance institutions.

Government tried to formalize the credit activities & started with co-operative movement which got failed, after the nationalization of banks, to solve the purpose of the poor Government created Regional Rural Banks. It was believed that RRB's would be run by barefoot managers, but then also the purpose was not solved& the gap between the poor & credit remained as it was earlier.

Ngo's came into existence in 70's but their reputation was very bad, they became a way to siphon of a lot of funds, but later the situation improved & they started up with the micro finance activities & improved their credibility.

Now while formal financial institutions had extensive infrastructures and systems and access to funds, they were usually further removed from rural or poor clients, making it very difficult to obtain adequate information and reducing risks. In contrast, these Ngo's & MFI's operate close to rural clients, possess quite good information and enforcement mechanisms and are typically more flexible and innovative. However, they were constrained in the services they can offer since informal institutions lack resources and infrastructure to serve clients beyond a small geographic area, resulting in highly concentrated loan portfolios.

Thus both the formal & informal financial institutions were in need of each other & thus this linkage was formed. Still Formal Financial institutions are cautious in giving loans to the MFI's because of past experiences, but slowly & steadily the situation is improving.

CRITICAL ANALYSIS OF THE WHOLE PROCESS

1. Interest Rates

Different formal financial institutions have different interest rates to lend credit to the MFI's; it varies from 1% to 14%, which creates operational problems for the MFI's.

MFI's cannot afford such high interest rates as their purpose is to lend to the poor.

Thus MFI's demand a Regulatory Authority to keep these interest rates, under a feasible limit. Moreover a single MFI deals with at least 8-9 Financial Institutions with equal no. of interest rates charged.

This table shows interest rates of few institutions for a particular MFI

Name of the Financial Institution	Interest Rates Charged
NMDFC	1%
Rashtriya Mahila Kosh	4%
SIDBI	9.25%
ICICI Bank	10%
DCBL	12%
ABN AMRO	13%

There are few other facts related to this-

- A particular Financial Institution has variable rates for different MFI's & it's not fixed for e.g. FWWB is charging only 11% from Gram-Utthan where as it is charging 12% from BISWA.

- Sometimes an MFI will prefer 11% interest rate of FWWB rather than 8% of NABARD,because of the following reason-

For e.g. organizations like FWWB will lend 1crore at the interest rate of 11%

But will lend another 1crore under its CSR activities at only 2%.Thus overall cost of borrowing for the MFI's comes down.

2. Cap on the interest rates MFI's can charge

This is another bottleneck of the system. Especially, banks try to have a control over the MFI in a way that the MFI's should not charge to the borrowers beyond a certain limit. For e.g. if State Bank Of India lends to the MFI at 11% it puts a cap on the MFI of 5%.thus they can lend at a maximum rate of 16%,some other banks put a cap of 4%.

In a way they try to regulate that rate, which is not acceptable to the MFI's.MFI's demand that they should not interfere in these rates because cost of operations for the MFI is very high & also it differs from MFI to MFI according to their geographical locations.

According to the MFI's if the putting up of this cap is a necessity to that it could help the poor than it should be at least 6% above the interest rates charged by the banks.

Moreover a regulatory mechanism should be introduced to keep a check on it.

3. Problems faced by the MFI's due to cap & variable rates

MFI's face tremendous problems in the fields because of this compulsion by the banks.

If an MFI is managing its operations at a certain interest rates from various SHG groups than it cannot suddenly change its interest rates because of a new lender, moreover it is hard for the MFI's to explain this phenomenon to several SHG groups which have taken loan at a higher interest. It creates confusion among the borrowers & puts a question mark on the operational credibility of the MFI's by its clients.

4. Compulsion of full dependency

It has come out that various commercial banks put up a lot of pressure on the MFI's to become fully dependant on them, they come out with innovative ideas & incentives so that the MFI should not take up loan from any other bank or institution.
In the past we have seen few MFI's accepting this norm & killing them for e.g. KAS

Foundation slowly & steadily became fully dependant on the ICICI Bank & when the bank suddenly stopped its credit activities the organization suffered its repercussions.
Its relationship with other financial institutions was already in a tattered state, thus it couldn't do much & suffered a lot.

5. Special conditions on the operational area

Banks sometimes have the problem in the geographical areas in which the MFI's are utilizing its credit, sometimes they define the areas themselves & sometimes they insists that credit from any other institution should not be used in those particular areas.

For e.g.

- State Bank of India insists that area of operation of the MFI where the credit is to be used should be such that, SBI branch should not be present there.
- Secondly few banks such as ABN AMRO ask few MFI's that a particular area should be assigned & credit from no other financial resources should reach to that area.

6. Problem due to above given condition

In the MFI's view Banks try to pose threat to the operations & existence of MFI's when

they demand for their own operational areas, Because, when a particular bank knows that a in certain area credit given by their bank is being disbursed, they try to generate awareness about the banks in those areas & try to divert those customers who have already made their financial condition better through some enterprise or through some other means, taking loan from the MFI. They teach that they can take loans directly from the banks at much cheaper rates.

Many a time's poor people cannot understand this & they question from the field staff of the MFI's as to why they are charging higher interest rates.

7. Various Models That Are Followed

There are various models which are being followed up by various financial institutions such as Partnership Model or Direct Loan Model which basically depend on the motive of the financial institutions, but there are few models which are proposed but are not at all accepted by the MFI's .For e.g. ICICI Bank came up with FINO Model which was appreciated by all others accept MFI's .This model is such wherein the MFI's have to give all the information about their clients to the bank & than has to face interference by the banks & solution of bank's queries

8. Terms & Conditions as in MoU between MFI's & Financial institution

There are various clauses in the MoU of the Banks which is being analyzed during the study, it seems that banks do not want to take any kind of risks & want to partner with the MFI's for the returns. For e.g. there are clauses like –

- …..Bank may terminate this agreement forthwith,& without giving any notice to the MFI,upon the failure of MFI to perform certain obligations…..
- ….Extraordinary circumstances which in opinion of the bank make it improbable for the MFI to fulfill its obligations under this agreement…the agreement would get cancelled
- …the personnel employed by the MFI shall not have any claim whatsoever against the Bank & shall not raise any dispute ,either

directly or indirectly ,with or against the bank, in respect of any of the service conditions or otherwise….

- MFI shall take the bank's permission before making any modifications to the sourcing criteria for loans under the agreement….
- …the banks have the right to inspect all the times…..the cost of such inspections will be borne by the borrower….

9. Improper Communication by these lending Institutions especially banks

MFI's say that charges are cut from their current & savings account without giving them any prior notice about it, they come to know about the fact only when they want to take out money from their accounts for their operational purposes.

10. No Incentives for these Financial Institution

MFI's say that banks lack motivation in maintaining this relationship .This Linkage serves for them to meet their priority sector targets & nothing else so most of the time the balancing factors between both the parties is missing ,resulting in one dominating over other.

Apart from all the negative points that are states MFI,s do praise the banks for certain things ,they could be summed up as follows

1. According to MFI's they are in huge need of credit & there is tremendous demand for micro finance in the market & that could not be met through any other means but through the banks etc.So the MFI's are happy with the availability of the Funds.

2. MFI's say that few banks come a step ahead in giving credit to them ,even when they are following such a strict rules & regulations.

3. They do not interfere in the selection of the clients etc & fixing up of the repayments.

4. Clauses in the Terms & condition of certain banks ,make MFI's as equal partners in the linkage for eg.in T&C of the AXIS banks it says-

   - ...the bank will be free to suitably modify the terms & conditions detailed above whenever necessary. This will off course be done in consultation with the borrower.....
   - ...the rate of interest charged by the borrower to its microfinance clients should be reasonable & in tune with the prevailing market rate of interest....

RECOMMENDATIONS

There are various things which can be recommended after the study is being done-

- MFI's should improve their operational & financial efficiency to become more accountable & responsible in respect to the formal financial institutions, so that they can play equal role in the partnership.

- There should be some regulatory authority to regulate the Micro Finance Institutions so that Formal financial Institutions can lend to them without suspecting their credibility & charge the nominal rates. So that the purpose of having MFI's could be solved i.e. serving the poor who cannot directly take credit from the banks.

- There should also be some regulation, which should define the relationship, i.e. the linkages between the MFI's & formal financial institutions. It should formulate standard terms & conditions, fixed interest rates for lending etc taken into account various conditions, for proper functioning of this link.

- One major recommendation is that instead of giving term loans banks should go for Cash Credit limit, which very well gels up with the operations of MFI. Why CC limit is better for MFI's!!
  1. MFI's can use only amount needed and will pay interest on that only in
  case of CC limit, which is ideal for their business model.

2. CC limit never gets over and is renewed annually which help them to maintain good liquidity.

3. CC limit is mainly used for working capital requirements which augur well with MFI's.

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3. The Economic Times – News articles

Questionnaire for the bank's official (Annexure-1)

A.

1. Name of the Bank :-

2. Branch (Location) :-

3. Name of the Interviewee :-

4. Designation:-

B.

1. Are you associated with any Micro finance Institution in this area? Yes/no

2. If Yes, Name of the MFI?

3. How do you market about yourself to MFI's?

4. Form of Financial Association (if any)
    - Credit Lending to an MFI
    - Managing Daily Operational Accounts Of MFI's
    - Managing Saving Accounts of MFI
    - Any Other (please Specify)

C.

1. Eligibility criteria for MFI for credit lending?

2. Following any international rating? Yes/No

3. Various terms & conditions of Banks for Eligibility of an MFI?

4. Documents required to be presented before the bank?

5. What are the various filters for scrutiny?

6. Cost of Lending to MFI's?

7. Cost of Borrowing for MFI's?

8. Time taken in the whole process?

9. Selection/Rejection Criteria?

D.

1. Procedures of the credit lending?

2. Post financing follow-up (supervision)?

3. Recovery of credit(how)?

E.

1. Types of Accounts maintained by the MFI?

2. How many times they can operate (withdraw/deposit) in a day?

3. What are the services provided by the bank (withdrawal time etc)?

4. Cost of services provided (types of charges)?
5. Terms & Conditions for such an agreement?

F.

1. Any Benefits to the bank through this association? Yes /No

2. If Yes then what(with reasons)?

3. IF No, then reasons for that?

4. Problems faced in dealing with MFI's?

5. Want any changes in the whole criteria?

6. Any Suggestions or general comment on the linkage between the MFI & the Bank?

Questionnaire for the MFI(Annexure-2)

A.

1. Name:-
2. Location:-
3. Area of Operations:-
4. Legal status :-
5. Specific Objectives :-
6. Various Activities Undertaken :-
7. Capital Structure Of the MFI :-

B.

1. Association with any bank/s? Yes/No

2. Name of the bank/s?

3. Location /Branch?

4. What is the form of association with the bank?

C.

1. Different sources of Capital Generation?

2. % of total capital base borrowed by commercial banks?

3. Terms & Conditions of the banks?

4. Cost of borrowing?

5. Why do they choose the following bank (basis of selection)?

6. How does it differ from other lending institutions? (Positively & negatively)?

7. What is the process of loan application appraisal?

8. How credit worthiness is assessed by the banks?

9. Interference by the banks in post funding stage?
10.

11. Operational problems occurred:-
    - Pre-funding stage –
    - Post funding stage –

D.

1. Association with the bank for its daily operations?

2. No. of accounts maintained?

3. Type of accounts / there purpose?

4. Terms & Conditions of the banks?

5. Cost of service charged by the bank?

6. Operational problems faced by this system followed?

7. Benefits /Loses by such arrangement?(reasons)

8. Recommendation for the improvement in the policy?